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Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY and FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,
Petitioners,

versus

GEORGE W. DAVIS and CATHERINE V. DAVIS,
Respondents.

On Petition for a Writ of Certiorari to the Court of Appeals of Kentucky

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether a state violates the dormant Commerce Clause by providing an exemption from its income tax for interest income derived from bonds issued by the state and its political subdivisions, while treating interest income realized from bonds issued by other states and their political subdivisions as taxable to the same extent, and in the same manner, as interest earned on bonds issued by commercial entities, whether domestic or foreign.

PARTIES TO THE PROCEEDING

The Petitioners are the Department of Revenue and Finance and Administration of the Commonwealth of Kentucky.

The Respondents are George W. Davis and Catherine V. Davis.

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PETITION FOR A WRIT OF CERTIORARI

The Department of Revenue and Finance and Administration Cabinet of the Commonwealth of Kentucky respectfully petition this Court for a writ of certiorari to review the judgment rendered by the Kentucky Court of Appeals on January 6, 2006.

OPINIONS BELOW

The opinion of the Kentucky Court of Appeals is reported at 193 S.W.3d 557 (Ky. App. 2006). Pet. App. 1 - 13. The order of the Kentucky Supreme Court denying the Petitioner's motion for discretionary review of that opinion is unreported and is reprinted at Pet. App. 14. The order of the Jefferson Circuit Court that was reversed by the opinion of the Kentucky Court of Appeals is also unreported and is reprinted at Pet. App. 15 - 19.

STATEMENT OF JURISDICTION

The judgment of the Kentucky Court of Appeals was rendered on January 6, 2006. Pet. App. 1. The Petitioners timely filed a timely motion for discretionary review with the Kentucky Supreme Court on February 2, 2006, which was denied on August 17, 2006. Pet. App. 14. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Art. I, § 8, cl. 1 provides that "[t]he Congress shall have Power... To regulate commerce with foreign nations, and among the several States, and with the Indian tribes."

The relevant statutory and regulatory provisions – Ky. Rev. Stat. §§ 141.020 and 141.010 and 103 Ky. Admin. Regs. 17:060 – are reproduced at Pet. App. 20 - 23.

STATEMENT OF THE CASE

Kentucky law provides that "[a]n annual tax shall be paid for each taxable year by every resident individual of this state upon his entire net income as defined in this chapter." Ky. Rev. Stat. Ann. § 141.020(1). "The entire net income of a full-year resident individual is subject to Kentucky income tax regardless of its source" and "[i]ncome from out-of-state sources is not exempt." 103 Ky. Admin. Regs. 17:060 § 1. Persons who become Kentucky residents during the year and Kentucky residents who become nonresidents during the year are subject to Kentucky individual income tax upon their entire net income from any source while they are Kentucky residents. 103 Ky. Admin. Regs. § 17.060 §§ 2 (1) and 3(1). *See also* Ky. Rev. Stat. Ann. § 141.010(4), (6), and (7).[1]

"Net income" is defined in Ky. Rev. Stat Ann. § 141.010(11) as "adjusted gross income as defined in [Ky. Rev. Stat. Ann. § 141.010(10)]," minus various deductions further enumerated in Ky. Rev. Stat. Ann. § 141.010(11). Kentucky "[a]djusted gross income" is defined in Ky. Rev. Stat. Ann. § 141.010(10) as "gross income as defined in [Ky. Rev. Stat. Ann. § 141.010(9)], minus the deductions allowed individuals by section 62 of the Internal Revenue Code and as modified by [Ky. Rev. Stat. Ann. § 141.0101]" and adjusted further in Ky. Rev. Stat. Ann. § 141.010(10).

"Gross income" is defined in Ky. Rev. Stat. Ann. § 141.010(9) as " 'gross income' as defined in Section 61 of the Internal Revenue Code." Under Section 61 of the Internal

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[1] A nonresident individual, on the other hand, is subject to Kentucky income tax "only upon the amount of [net] income received by him from labor performed, business done, or from other activities in this state, from tangible property located in this state, and from intangible property which has acquired a business situs in this state." Ky. Rev. Stat. Ann. § 141.020(4). *See also* 103 Ky. Admin. Regs. 17:060 § 4.

Revenue Code, "interest received by or credited to the taxpayer constitutes gross income and is fully taxable." 26 C.F.R. § 1.61-7(a). This "[i]nterest income includes . . . interest on coupon bonds [and] interest on a corporate bond or debenture." *Id.* "[G]ross income does not include interest on any State or local bond" — i.e., any "obligation of a State or political subdivision thereof." 26 U.S.C. §§ 61(a), 103(a) and (c)(1); 26 C.F.R. § 1.61-7(b).[2]

Among the adjustments made to this federal gross income to arrive at Kentucky adjusted gross income is the inclusion or add-back of "interest income derived from obligations of sister states and political subdivisions thereof." Ky. Rev. Stat. Ann. § 141.010(10)(c). The effect of this provision is to provide an exemption from Kentucky income tax for interest income from bonds or obligations of the Commonwealth of Kentucky and its political subdivisions.[3]

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[2] Ky. Rev. Stat. Ann. § 141.050(1) states:

> Except to the extent required by differences between this chapter and its application and the federal income tax law and its application, the administrative and judicial interpretations of the federal income tax law, computations of gross income and deductions therefrom, accounting methods, and accounting procedures, for purposes of this chapter shall be as nearly as practicable identical with those required for federal income tax purposes.

[3] This exemption is reinforced by a number of statutory provisions that specifically exempt bonds of the Commonwealth from taxation. *See, e.g.*, Ky. Rev. Stat. Ann. § 164A.200 (Kentucky Higher Education Student Loan Corporation bonds); Ky. Rev. Stat. Ann. § 198.200 (Kentucky Housing Corporation bonds); Ky. Rev. Stat. Ann. § 224A.210 (revenue bonds or notes issued by the Kentucky Infrastructure Authority); Ky. Rev. Stat. Ann. § 154.20-035(12)(Kentucky Economic Development Finance Authority bonds and notes); Ky. Rev. Stat. Ann. § 56.514(3)(revenue bonds, notes and other obligations issued by State Property and Buildings Commission); Ky. Rev. Stat. Ann. § 56.869 (notes issued by the Kentucky Asset/Liability Commission).

The Respondents are "individual residents of Jefferson County, Commonwealth of Kentucky" who paid Kentucky income tax "on interest income derived from obligations of sister states and/or their political subdivisions." They brought this action for declaratory and injunctive relief and tax refunds in the Circuit Court of Jefferson County, Kentucky. The Respondents asserted that Kentucky's income tax violated the Commerce Clause by "discriminat[ing] on its face against the holders of obligations of sister states and/or their political subdivisions . . . by imposing a tax and corresponding burden on such interest income that is greater than that imposed on interest income derived from obligations of the Commonwealth of Kentucky and its political subdivisions." They also alleged that Kentucky's law violated the Equal Protection Clause and Sections 3 and 171 of the Kentucky Constitution, because "it does not tax in-state interest and out-of-state interest, otherwise similar in economic substance, at the same rate."

The Petitioners moved for summary judgment.[4] On August 30, 2004, the Jefferson Circuit Court granted the Petitioners' motion. Pet. App. 15 - 19. The court relied upon the market participant doctrine in ruling that Kentucky's law did not violate the Commerce Clause. Pet. App. 18 (*citing Reeves, Inc.* v. *Stake*, 447 U.S. 429 (1980) and *Hughes* v. *Alexandria Scrap Corp.*, 426 U.S. 794 (1976)). The court observed that "[w]hen a state issues municipal bonds, it participates in the bond market by supplying bonds in the market and paying interest on those bonds."

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[4] The Petitioner Department of Revenue is the department of the Petitioner Finance and Administration Cabinet that "exercise[s] all administrative functions of the [Commonwealth of Kentucky] in relation to the [Commonwealth's] revenue and tax laws." Ky. Stat. Ann. §§ 131.030(1); 12.020, II, 7; 42.012; 42.014.

Pet. App. 18. Finally, the circuit court found that Kentucky's law otherwise had "a reasonable, legitimate purpose" and was therefore constitutional. Pet. App. 19.

The Respondents appealed the circuit court's order granting the Petitioners' motion for summary judgment to the Kentucky Court of Appeals. On January 6, 2006, the Court of Appeals rendered an opinion vacating the circuit court's decision and remanding the case for further proceedings. Pet. App. 1, 13. The court held that "[c]learly, Kentucky's bond taxation system is facially unconstitutional [under the Commerce Clause] as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds."[5] Pet. App. 6. It found that "none of the arguments in favor of its constitutionality offered by the [Petitioners] or relied upon by the [circuit court] are sufficient to save it." Pet. App. 10. The Court of Appeals stated the following with respect to the market participant doctrine:

> The [Petitioners'] market participant argument is unavailing, however. No one could seriously argue against the principle that Kentucky acts as a market participant when it issues bonds. But Kentucky's issuance of bonds is not the issue. Rather, the sole issue is Kentucky's decision to tax only extraterritorial bonds. Thus, the market participant theory is inapplicable as a State's "assessment and computation of taxes" is, clearly, "a primeval governmental activity." Therefore, the [Petitioners'] market participant argument is without merit.

Pet. App. 10 (footnotes omitted).

Pursuant to Kentucky Civil Rule 76.20, the Petitioners timely filed a motion for discretionary review of the Court

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[5] The Court of Appeals did not reach the Respondents' other federal constitutional claim, stating that "[g]iven our Commerce Clause analysis, we also find it unnecessary to engage in an Equal Protection analysis." Pet. App. 11.

of Appeals' opinion with the Kentucky Supreme Court. On August 17, 2006, the Supreme Court denied the Petitioners' motion. Pet. App. 14.

REASONS FOR GRANTING THE WRIT

I. THIS CASE PRESENTS AN IMPORTANT QUESTION OF FEDERAL CONSTITUTIONAL LAW ON WHICH THE COURTS BELOW ARE DIVIDED.

This case presents a pure question of federal constitutional law not dependent on the presence or development of any particular facts. Relying upon the Commerce Clause, the Kentucky Court of Appeals held unconstitutional on its face a provision of Kentucky's income tax law that taxed the interest income from bonds issued by Kentucky's sister states and their political subdivisions, while not taxing interest income from bonds issued by Kentucky and its political subdivisions. Pet. App. 6.

This decision is squarely at odds with the decision of the Ohio Court of Appeals in *Shaper* v. *Tracy*, 97 Ohio App.3d 760, 647 N.E.2d 550 (1994), *motion to certify den.*, 71 Ohio St.3d 1477, 645 N.E.2d 1257 (1995), *cert. den.*, 516 U.S. 907 (1995). The court in *Shaper* upheld against Commerce Clause challenge a state income tax law indistinguishable from Kentucky's law. 647 N.E.2d at 552. The Ohio court found that "neither the Supreme Court nor any case law examined has applied the Commerce Clause to a case such as this, where one governmental entity is taxing its residents for the interest earned on bonds issued by another government entity." *Id.* at 552, 553. The Ohio Court of Appeals rejected the application of the market participant doctrine, although it recognized that "[e]ach state has a legitimate interest in tapping a major source of tax revenue while adding an incentive for investors to purchase state bonds" and that "[t]hose investors then become the major beneficiaries of the issuance of the bonds for

state issues, capital improvements and similar benefits." *Id.* at 552, 553 (internal quotation marks omitted). The Ohio court instead upheld its law based upon its conclusion "that the Commerce Clause was simply never intended to apply to acts of a sovereign on behalf *of itself* where the end result is to provide the taxing state with a competitive advantage over *another* sovereign." *Id.* at 552, 553-54 (emphasis by court).

The significance of this issue runs both broad and deep. First, the issue affects the overwhelming majority of the states. Kentucky and Ohio are two of thirty-eight states whose income tax laws subject interest earned on bonds issued by other states and their political subdivisions to taxation while exempting interest earned on their own bonds.[6] *The Bond Buyer/Thomson Financial 2006 Yearbook at* 102-03 (Source Media 2006). Another four states

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[6] Ala.Code § 40-18-14(3)f (2003); Ariz. Rev. Stat Ann. § 43-1021(3) (West 2006); Ark.Code Ann. § 26.51-404(b)(5) (Michie 2005); Cal. Rev. & Tax Code § 17133 (West 2004); Colo Rev. Stat. § 39-22-104(3)(b); Conn. Gen. Stat. § 12-505(a)(4)(B)(West 2000); Del. Code. Ann. tit. 30, § 1106(a)(1)a. (1997); Ga. Code. Ann. § 48-7-27(b)(1)(A)(Michie 2005); Haw. Rev. Stat. § 235-7(a)(5), (b)(2)(2002); Idaho Code § 63-3022 M(1) and (3)(b) (2000); Kan. Stat. Ann. § 79-32, 117(b)(i)(1997); La. Rev. Stat. Ann. § 47.293(6)(a)(West 2001); Me Rev. Stat. Ann., tit. 36 § 5122 (A)(West 2005); Md. Code Ann., Tax-Gen. §§ 10-203 and 10-204 (a) and (b)(2004); Mass. Gen. Laws. Ann. Ch. 62, § 2(a)(1)(A)(2001); Mich. Comp. Laws § 206 30 (1)(a)(West 2003); Minn. Stat. Ann. § 290.01 (19a)(1) (1)(West 1999); Miss. Code Ann. § 27-7-15(4)(d)(West 2006); Mo. Rev. Stat. § 143.121(2)(b)(West 2006); Mont. Code Ann. § 15-30-111(1)(a)(2005); Neb. Rev. Stat. § 77-2716(1)(c)(2003); N.H. Rev. Stat. Ann. § 77.4(I)(2001); N.J. Rev. Stat. § 54A: 6-14 (West 2002); N.M. Stat. Ann. § 7-2-2(B)(3) and (V)(2001); N.Y. Tax Law § 612(b)(1) (West 1999); N.C. Gen. Stat. § 105-134.6 (c) (1)(2005); N.D. Cent. Code § 57-38-01.2(1)(g)(2005); Ohio Rev. Code Ann. §

(Continued next page)

exempt interest earned on some bonds issued by them or their political subdivisions while taxing interest earned on all bonds issued by other states and their political subdivisions. *Id.*[7] *See also* Scott K. Attaway, Note, *The Case for Constitutional Discrimination in Taxation of Out-of-State Municipal Bonds* 76 B.U.L. Rev. 737, 738, n. 4 (1996).

Second, states and local governments rely heavily upon the issuance of debt to finance public projects. Justice O'Connor in her dissent in *South Carolina* v. *Baker*, 485 U.S. 505 (1988) observed:

> Long-term debt obligations are an essential source of funding for state and local governments. In 1974, state and local governments issued approximately $23 billion of new municipal bonds; in 1984, they issued $102 billion of new bonds. Report of Special Master 20. State and local governments rely heavily on borrowed funds to finance education, road construction, and utilities, among other purposes. As the Court recognizes, States will have to increase the interest rates they pay on bonds by 28-35% if the interest is subject to the federal income tax. *Ante*, at 511. Gov-

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5747.01 (A)(1)(West 2002); Okla Stat. Ann. tit. 68, § 2358(A)(1)(West 2002); Or. Rev. Stat. § 316.680(2)(a)(2005); 72 Pa. Cons. Stat. Ann. § 7302 and 7303(a)(3) and (6)(West 2000); R.I. Gen. Laws § 44-30-12(a) and (b)(1)(2005); S.C. Code Ann. § 12-6-1120(1)(West 2000); Tenn. Code Ann. § 67-2-104(e)(2003); Vt. Stat. Ann. tit. 32, § 5811(18)(A)(i)(II)(2005); Va. Code Ann. § 58.1-322 (B)(1)(2004); W. Va. Code § 11-21-12(b)(1)(2005).

[7] One state (Utah) exempts its own bonds and those out-of-state bonds purchased after January 1, 2003 from issuers in states that do not tax interest income received from Utah bonds. *Id.* One state (Indiana) exempts all interest on bonds issued by states and their political subdivisions. *Id.* Six states do not impose an income tax. *Id.*

> ernmental operations will be hindered severely if the cost of capital rises by one-third. If Congress may tax the interest paid on state and local bonds, it may strike at the very heart of state and local government activities.

Id. at 531-32. A recent publication of the Statistics of Income Division of the Internal Revenue Service reports:

> State and local governmental units issued nearly $2.1 trillion of tax-exempt bonds between 1996 and 2002. The majority ($1.5 trillion) of these tax-exempt bonds were Governmental bonds, the proceeds of which helped finance public projects (such as schools, streets, and utilities). The balance, $0.5 trillion, comprised private activity bonds, the proceeds of which were used for qualified facilities (such as airports, docks and wharves, and solid waste disposal facilities), as well as to benefit Internal Revenue Code section 501(c)(3) organizations (such as hospitals and private universities).

Cynthia Belmonte, *Tax-Exempt Bonds, 1996-2002*, at 151 (SOI Bulletin Summer 2005), available at http://www.irs.gov/pub/irs-soi/02govbnd.pdf.

Credit is of course a matter of vital importance to state and local governments. As the Georgia Supreme Court noted almost a century ago:

> The government, whether it be the state or one of its political subdivisions, is dependent, for the due exercise of its powers, on certain instrumentalities needful and proper in the matter with which it is dealing. Credit is absolutely indispensable to any government, whether it exists in the form of a state government or in the form of the government of one of the political subdivisions of the state. It becomes necessary, in the life of a state, as well as of its political subdivisions, to be able to establish credit in order to carry on successfully and properly the governmental functions. One of the most usual and ordinary methods of using the

> credit of a government is by the issue of securities and placing them in the markets of the world for sale.

Penick v. *Foster*, 129 Ga. 217, 58 S.E. 773, 775 (1907). The importance of credit extends to all levels of government. For 2002, "[a]lmost 50 percent of the total number of new money long-term Governmental bond issues were for small bonds with an issue price of less than $1 million." Belmonte, *supra* at 154. These bonds "were generally issued by smaller towns for purposes such as school buses, fire trucks, and other unspecified expenditures." *Id.*

Tax exemptions such as the one at issue in this case facilitate the vital function of borrowing by governments. Their role has been described as follows:

> If [outstanding public bonds] are held to be taxable, the inevitable result will be that the rate of interest is increased. If the rate of interest is increased, additional taxes would be required to pay it. No practical benefit would be derived. The operation of local government would be hampered and impeded and the funds and property of the issuing body materially affected.

In re Droll, 108 Neb. 85, 187 N.W. 876, 878 (1922). This point was echoed in *Fidelity Guarantee Mortgage Corp.* v. *Connecticut Housing Authority*, 532 F.Supp. 81 (D.Conn. 1982):

> The Connecticut Housing Finance Authority, ("CHFA"), was established by the Connecticut General Assembly in 1969 in order to alleviate the shortage of housing for low and middle income families and to encourage those families to settle in designated urban areas within the State. To achieve this end, CHFA is empowered to issue bonds the proceeds of which are made available as mortgage loans to qualified families. Because CHFA is a political subdivision of the State, the interest paid to bondholders on the bonds is tax exempt under provisions of the Internal Revenue Code.

> CHFA is thus able to offer the bonds at lower interest rates than would have to be paid by a private entity. This, in turn, enables CHFA to charge lower rates of interest on the mortgage loans to qualified borrowers.

Id. at 82 (footnotes omitted). *See also* Belmonte, *supra* at 151 (noting that tax exemption for state and local bond interest "effectively lowers the borrowing cost of tax exempt debt issuers, since bondholders are generally willing to accept an interest rate lower than that earned on comparable taxable bonds").

The decision of the Kentucky Court of Appeals, if allowed to stand, creates considerable uncertainty for a significant number of states and their political subdivisions in this critical area of public finance. State and local governments will not know for sure whether one of their costs of borrowing money will include providing "meaningful backward-looking relief" — tax refunds or the collection of back taxes from the impermissibly favored taxpayers — if their courts agree with the Kentucky Court of Appeals. *McKesson* v. *Division of Alcoholic Beverages and Tobacco, Department of Business Regulation of Florida*, 496 U.S. 18, 31, 39-41 (1990). They would also risk the complete loss of the ability to exempt their bonds or the interest therefrom if their courts opted for that approach as a prospective remedy. *Davis* v. *Michigan Dept. of Treasury*, 489 U.S. 803, 817-18 (1989)(stating that "[w]e have recognized, in cases involving invalid classifications in the distribution of government benefits, that the appropriate remedy is a mandate of equal treatment, a result that can be accomplished by withdrawal of benefits from the favored class as well as by extension of benefits to the excluded class' " and holding that the state courts were "in the best position to de-

termine how to comply with the mandate of equal treatment").[8]

Under the Kentucky court's decisions, state and local governments will lose an important advantage in a limited market — their taxpayers — on which they rely as a source of funds raised through borrowing. Tax exemptions such as that at issue in this case allow state and local governments to pay less interest and offset advantages that bonds of other jurisdictions with higher credit ratings enjoy. *See* Robert Zipf, *How the Bond Market Works*, at 54 (2nd ed. 1997). The tax exemption influences a Kentucky resident to choose to acquire a bond issued by Kentucky or a Kentucky municipality over a bond issued by another state or other state's municipality that pays a higher rate of interest or has a stronger credit rating. If the Kentucky court's decision stands, state and local governments will lose this important edge in seeking to borrow from their taxpayers for the benefit of their respective constituencies.

Therefore, the practice held invalid by the Kentucky Court of Appeals is one that is not only widespread among the states, but one that is one of great ongoing importance to the funding of public projects. The issue presented by this case will therefore certainly arise again. If this issue is not addressed now, the dormant Commerce Clause will not only mean one thing in Kentucky and quite another in Ohio, but there will be considerable doubt and uncertainty as to the validity of a practice engaged in by the great majority of states. This is also a practice which the states

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[8] Similarly, prospective purchasers and holders of these bonds would face the risk of efforts to collect back taxes in the event of a state court's adherence to the Kentucky court's decision. *McKesson*, 496 U.S. at 39-41. They would also face the risk of losing the state tax exemption prospectively if a state court held that to be the appropriate remedy. *Davis*, 489 U.S. at 817-18.

substantially rely "to raise capital for essential public facilities, infrastructure, and general capital improvements." Belmonte, *supra* at 151.

The potential ramifications of the decision below therefore consist of the crippling, and possibly the demise, of a practice of great importance to the states and their taxpayers, particularly those who provide the very capital to fund needed infrastructure and other public purposes.[9] It is a practice that enables the states to raise needed funds and serve their citizens at less cost. This Court should address this issue now to eliminate the uncertainty as to the validity of this salutary practice.

I. THE DECISION BELOW IS AT ODDS WITH PRIOR DECISIONS OF THIS COURT AND PRESENTS AN IMPORTANT CONSTITUTIONAL QUESTION THAT SHOULD BE SETTLED BY THIS COURT

This Court has admonished that under the dormant Commerce Clause, "the result turns on the unique charac-

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[9] The significance of this case extends beyond its particular context. For example, the Kentucky court's decision in this case calls into question tax exemptions for property owned by a taxing state but not property owned by other states. *See, e.g., State* v. *City of Hudson*, 231 Minn. 127, 42 N.W.2d 546, 549 (1950); *State ex rel. Taggart* v. *Holcomb*, 85 Kan. 178, 116 P. 251, 253 (1911); *City of Cincinnati* v. *Commonwealth*, 292 Ky. 597, 167 S.W.2d 709, 714-15 (1942); *Warren County* v. *Hester*, 219 La. 763, 54 So.2d 12 (1951). The rationale behind tax exemptions for property of a state and its municipalities is that in the absence of such an exemption, the public would be taxing itself to raise money to pay itself. *See, e.g., Van Buren Hospital and Clinics* v. *Board of Review of Van Buren County*, 650 N.W.2d 580, 586-87 (Iowa 2002). Under the Kentucky court's decision in this case, one could argue that a state must treat property within its jurisdiction that is owned by another state in the same manner for tax purposes as its own property — despite the obvious absence of the public policy justification for the exemption.

teristics of the statute at issue and the particular circumstances in each case." *Boston Stock Exchange* v. *State Tax Commission*, 429 U.S. 318, 329 (1977). *See also Freeman* v. *Hewitt*, 329 U.S. 249, 252 (1946) ("Suffice it to say that especially in this field opinions must be read in the setting of the particular cases and as the product of preoccupation with their special facts"). The decision below failed to heed this admonition.

None of the decisions relied upon by the Kentucky Court of Appeals addressed facts even remotely similar to those presented by this case. Discrimination against interstate commerce in the contexts of those cases consisted of "economic protectionism – that is, 'regulatory measures designed to benefit in-state *economic interests* by burdening out-of-state *competitors*.' " *Associated Industries of Missouri, Inc.* v. *Lohman*, 511 U.S. 641, 647 (1994)(emphasis added). In *Oklahoma Tax Commission* v. *Jefferson Lines, Inc.*, 514 U.S. 175 (1995), this impermissible discrimination against interstate commerce was described as follows:

> A state may not "impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to *local business*." . . . Thus, States are barred from discriminating against *foreign enterprises* competing with *local businesses* . . . and from discriminating against *commercial* activity occurring outside the taxing State . . .

Id. at 197 (emphasis added)(citations omitted). Such is not the case here. Instead, what is at issue in this case is not a tax law that "benefit[s] a private industry or business in the state, to the detriment of out-of-state businesses," but one where a sovereign is acting on its own behalf in the service of its citizens in a manner that favors itself over other sovereign states. *Shaper*, 647 N.E.2d at 552.

The states are not mere economic interests or business enterprises, but sovereigns that function as such. *Alden* v.

Maine, 527 U.S. 706, 713-715 (1999); *New York* v. *United States*, 505 U.S. 144, 162-63, 188 (1992). This Court has fashioned the market participant doctrine, recognizing that "nothing in the purpose animating the Commerce Clause prohibits a State, in the absence of congressional action, from participating in the market *and exercising the right to favor its own citizens over others.*" *Hughes* v. *Alexandria Scrap Corp.*, 426 U.S. 794, 810 (1976)(footnotes omitted)(emphasis added). This Court has further stated that:

> [t]he Commerce Clause responds principally to state taxes and regulatory measures impeding *free private trade* in the national marketplace . . . There is no indication of a constitutional plan to limit the ability of the States themselves to operate freely in the free market.

Reeves, Inc. v. *Stake*, 447 U.S. 429, 436-37 (1980)(emphasis added)(citations omitted).

"Restraint in this area," this Court stated in *Reeves*, is "counseled by considerations of state sovereignty, the role of each state as guardian and trustee for its people." *Id.* at 438 (internal quotation marks omitted). In rejecting a claim of economic protectionism in violation of the Commerce Clause, this Court further explained:

> We find the label "protectionism" of little help in this context. The State's refusal to sell to buyers other than South Dakotans is "protectionist" only in the sense that it limits benefits generated by a state program to those who fund the state treasury and who the State was created to serve. Petitioner's argument apparently also would characterize as "protectionist" rules restricting to state residents the enjoyment of state educational institutions, energy generated by a state-run plant, police and fire protection, and agricultural improvement and business development programs. Such policies, while perhaps "protectionist" in

> a loose sense, reflect the essential and patently unobjectionable purpose of state government — to serve the citizens of the State.

Id. at 442.

As we have seen *supra*, the purpose of the tax exemption in question is to facilitate government borrowing by making it less costly for the government to enter the capital market. The purpose of a state's entry into the market is to raise needed funding for government purposes and public projects. The tax exemption is an inducement to persons subject to the state's income tax law — primarily its residents — to loan the state needed funds. It makes bonds of Kentucky and its political subdivisions competitive in this limited market with corporate bonds and bonds of other states and their political subdivisions that pay higher rates of interest or that have better credit ratings.

Therefore, this is a case of a state participating in a market in such a manner as to favor its interests and citizens over others. *Hughes*, 426 U.S. at 809-10. The State is inducing its citizens (or those persons otherwise subject to its tax laws) to loan it money to finance public purposes and projects that benefit and serve those citizens. *See, e.g.*, Belmonte, *supra* at 151 ("A bond is an interest-bearing security of indebtedness, i.e., an obligation by the issuer to repay a certain sum of money by a future date, with interest payable at a specified rate"). The tax exemption is essential to the state's marketing of its bonds to its residents, a "discrete, identifiable class of economic activity in which the [state and its political subdivisions are] major participant[s]." *White* v. *Massachusetts Council of Construction Employers, Inc.*, 460 U.S. 204, 211, n. 7 (1983)(holding that dormant Commerce Clause was not violated by a city executive order requiring all construction projects funded in whole or in part by the city or by city funds to be performed by a work force consisting of at least half bona fide residents of the city).

The Kentucky Court of Appeals relied upon *New Energy Company of Indiana* v. *Limbach*, 486 U.S. 269 (1988) in rejecting the application of the market participant doctrine to this case. Pet. App. 10. The linchpin of its holding was the following passage from that opinion:

> The market-participant doctrine has no application here. The Ohio action ultimately at issue is neither its purchase nor its sale of ethanol, but its assessment and computation of taxes – a primeval governmental activity.

Id. at 277. This language must be read in light of the facts before the Court in that case, *see Boston Stock Exchange*, 429 U.S. at 329; *Freeman* v. *Hewitt*, 329 U.S. at 252, which consisted of the effect of a tax credit scheme upon *private* purchases and sales of ethanol. The Petitioners submit that the Kentucky action ultimately at issue in this case is Kentucky's participation in a limited segment of the bond market. The tax exemption at issue is part and parcel of that market participation and in this context is not simply a "primeval governmental activity."

The application of the market participant doctrine by the Kentucky Court of Appeals therefore conflicts with prior decisions of this Court. The meaning of the passage from *New Energy* relied upon by the Kentucky court is a matter that can only be settled by this Court.

The decision of the Kentucky Court of Appeals is also at odds with this Court's decision in *Bonaparte* v. *Tax Court*, 104 U.S. 592 (1881). At issue in that case was "whether the registered public debt of one State, exempt from taxation by the debtor State, or actually taxed there, is taxable by another State when owned by a resident of the latter State." 104 U.S. at 594. This Court held that "[w]e know of no provision of the Constitution of the United States which prohibits such taxation." Id. It reasoned:

> It is true, if a State could protect its securities from taxation everywhere, it might succeed in borrowing money at reduced interest; but, inasmuch as it cannot secure such exemption outside of its own jurisdiction, it is compelled to go into the market as a borrower, subject to the same disabilities in this particular as individuals. While the Constitution of the United States might have been so framed as to afford relief against such a disability, it has not been, and the States are left free to extend the comity which is sought, or not, as they please.

Id. at 595. This reasoning is consistent with that of the later case of *Georgia* v. *Chattanooga*, 264 U.S. 472 (1924):

> Land acquired by one State in another State is held subject to the laws of the latter and to all the incidents of private ownership. The proprietary right of the owning state does not restrict or modify the power of eminent domain of the state wherein the land is situated . . . The sovereignty of Georgia was not extended into Tennessee. Its enterprise in Tennessee is a private undertaking. It occupies the same position there as does a private corporation authorized to own and operate a railroad, and, as to that property, it cannot claim sovereign privilege or immunity.

Id. at 480-81 (citations omitted). *See also Nevada* v. *Hall*, 440 U.S. 410, 424-27 (1979) (holding that sovereign immunity of one state is not required to be honored by courts of another state).

The Kentucky Court of Appeals dismissed *Bonaparte* as inapplicable because the challenge there was premised upon the Full Faith and Credit Clause (Art. IV, § 1). Pet. App. 9. The *Bonaparte* Court's reasoning which formed the basis of its holding was not so narrow, however. It expressly stated that "*no provision* of the Constitution . . . prohibit[ed] such taxation," id. at 594 (emphasis added), and that a State outside of its own jurisdiction "must go

into the market as a borrower, subject to the same disabilities in this particular as individuals." *Id.* at 595.

The decision of the Kentucky court conflicts with *Bonaparte*. Kentucky's law treats bonds of other states and their political subdivisions in the same manner as bonds issued by private issuers. The Kentucky Court of Appeals held that this was not enough; that instead Kentucky must effectively allow other states' sovereignty to cross state lines into Kentucky, thereby entitling those states' bonds to the same legal stature as bonds issued by Kentucky. This is squarely at odds with the conception of the extent of a state's sovereignty expressed in *Bonaparte* and later cases, as well as the holding of *Bonaparte* that any favorable tax treatment of another state's bonds was strictly a matter of comity on the part of the taxing state.

Perhaps viewed another way, the Kentucky court's decision overlooks the threshold Commerce Clause principle that "any notion of discrimination assumes a comparison of substantially similar entities." *General Motors Corp.* v. *Tracy*, 519 U.S. 278, 298-99 (1997). *See also Kraft General Foods, Inc.* v. *Iowa Dept. of Revenue*, 505 U.S. 71, 80, n. 23 (1992). With respect to Kentucky's taxing jurisdiction, other states and their political subdivisions are not similarly situated to Kentucky and its political subdivisions. Those other states do not come into the Kentucky market as sovereigns but instead as private entities. *Bonaparte*, 104 U.S. at 595.

Finally, the view of the dormant Commerce adopted by the Court below commandeers Kentucky's tax laws to subsidize other states' public debt if it wishes to exempt its own debt from taxation. In *New York* v. *United States*, the Court stated that "[i]n providing for a stronger central government, the Framers explicitly chose a Constitution that confers upon Congress the power to regulate individuals, not States." 505 U.S. at 166. "The allocation of power

contained in the Commerce Clause, for example, authorizes Congress to regulate interstate commerce directly; it does not authorize Congress to regulate state governments' regulation of interstate commerce." *Id.* The Kentucky Court of Appeals' decision *mandates* what should instead be a matter of comity and is inconsistent with the Constitution's Tenth Amendment.

Therefore, the decision of the Kentucky Court of Appeals is contrary to prior decisions of this Court. It presents a pure question of law — the meaning and scope of the Constitution's dormant Commerce Clause — whose determination is dependent solely upon an analysis of this Court's precedents. Thus, it is an issue that can only be settled by this Court and one whose resolution cannot be aided by further consideration by lower courts.

CONCLUSION

For the reasons stated above, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

RENDERED: JANUARY 6, 2006; 10:00 A.M.
TO BE PUBLISHED

COMMONWEALTH OF KENTUCKY
COURT OF APPEALS
NO. 2004-CA-001940-MR

GEORGE W. DAVIS and
CATHERINE V. DAVIS - - - - - - *Appellants*

v.

DEPARTMENT OF REVENUE OF THE FINANCE AND ADMINISTRATION CABINET, COMMONWEALTH OF KENTUCKY (FORMERLY COMMONWEALTH OF KENTUCKY, REVENUE CABINET) AND COMMONWEALTH OF KENTUCKY FINANCE AND ADMINISTRATION CABINET - - - - - - - - - - *Appellees*

OPINION VACATING AND REMANDING

BEFORE: BARBER, MINTON, AND TAYLOR, JUDGES.
MINTON, JUDGE:

I. INTRODUCTION.

George and Catherine Davis appeal from the Jefferson Circuit Court's grant of summary judgment in favor of the Department of Revenue of the Finance and Administration Cabinet for the Commonwealth of Kentucky ("the Department"). Because we find that Kentucky's tax on the income derived from bonds issued outside Kentucky violates the Commerce Clause of the United States Constitution, we vacate, and remand.

II. FACTUAL BACKGROUND AND PROCEDURAL HISTORY.

Although the legal theories involved are quite complex,[1] the pertinent facts of this case are simple. Kentucky Revised Statute (KRS) 141.020 governs individual state income taxes. Similar provisions exist for the Commonwealth to tax estates, trusts, and fiduciaries,[2] as well as corporations.[3] KRS 141.020 requires an individual to pay state taxes upon a percentage of that person's net income.[4] For individuals, net income is determined by making certain deductions from the individual's adjusted gross income.[5] In turn, an individual's adjusted gross income is derived by making certain deductions from a person's gross income "as defined in Section 61 of the Internal Revenue Code."[6] In arriving at its definition of gross income, the Internal Revenue Code specifically exempts interest earned on any state or local bond.[7] But Kentucky law requires that "interest income derived from obligations of sister states and

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[1] Indeed, even the United States Supreme Court once declared its own jurisprudence involving the dormant Commerce Clause to be a "quagmire" which left "much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation." Northwestern States Portland Cement Co. v. State of Minn., 358 U.S. 450, 457-458 (1959).

[2] KRS 141.030.

[3] KRS 141.040.

[4] KRS 141.020(1); KRS 141.030(1); KRS 141.040(1).

[5] KRS 141.010(11) provides that "'[n]et income' in the case of taxpayers other than corporations means adjusted gross income as defined in subsection (10) of this section, minus the standard deduction allowed by KRS 141.081, or, at the option of the taxpayer, minus the deduction allowed by KRS 141.0202 . . . ."

[6] KRS 141.010(9), (10). Section 61 of the Internal Revenue Code is codified at 26 U.S.C. § 61.

[7] 26 U.S.C. § 103 provides that "gross income does not include interest on any State or local bond."

political subdivisions thereof" is to be included in a person's adjusted gross income.[8] The cumulative impact of those various statutes is that Kentucky exempts from taxation interest income derived from bonds issued by the Commonwealth of Kentucky or its subdivisions but requires taxes to be paid on interest income derived from bonds issued by a sister state or its subdivisions.

In April 2003, the Davises filed a class action declaratory judgment complaint alleging that Kentucky's decision to tax the income earned on out-of-state bonds in this manner violates the Commerce Clause of the United States Conmstitution and the Equal Protection Clause of the Fourteenth Amendment to the United States Constitution. To attempt to demonstrate standing, the Davises alleged in their complaint that they were residents of Jefferson County who had paid Kentucky income tax on the income they earned from out-of-state bonds.

In July 2003, before the Davises had filed a motion for class certification, the Department filed a motion for summary judgment arguing that the tax system in issue was constitutional and that, furthermore, the Davises lacked standing to challenge the tax provisions applicable to corporations, estates, and trusts. In August 2004, the Jefferson Circuit Court granted the Department's motion for summary judgment on both the constitutionality of the bond taxation system and the question of the Davises' standing. The Davises filed this appeal.

III. ANALYSIS.

The Davises' appeal presents two issues. First, did the trial court correctly grant summary judgment to the Department on the Davises' claim that Kentucky's system of taxing only out-of-state bonds is unconstitutional? Second, did the trial court correctly find that the Davises lacked standing to assert claims on behalf of corporations, trusts,

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[8] KRS 141.010(10) (c). Similarly, "interest income derived from obligations of sister states and political subdivisions thereof" is included in a corporation's gross income. KRS 141.010(12)(c).

estates, and all other non-individual plaintiffs? Following a recitation of the applicable standards of review, each question will be addressed separately.

A. Standard of Review.

Summary judgment is appropriate only if the Department showed that the Davises "could not prevail under any circumstances."[9] In ruling on a motion for summary judgment, we must view the evidence in the light most favorable to the Davises.[10] An appellate court reviewing a grant of summary judgment must determine whether the trial court correctly found that there were no genuine issues of material fact.[11] As findings of fact are not at issue, the trial court's decision is entitled to no deference.[12]

B. Constitutionality of Kentucky's Taxation System.

"The test of the constitutionality of a statute is whether it is unreasonable or arbitrary."[13] A statute is constitutionally valid "if a reasonable, legitimate public purpose for it exists, whether or not we agree with its' 'wisdom or expediency.' "[14] The Davises' burden is heavy as "[a] strong presumption exists in favor of the constitutionality of a statute."[15]

Bearing these principles in mind, we now turn our attention to the Davises' contention that Kentucky's system of taxing only extraterritorial bonds violates the Commerce

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[9] Steelvest, Inc. v. Scansteel Service Center, Inc., 807 S.W.2d 476, 480 (Ky. 1991) (citing Paintsville Hosp. Co. v. Rose, 683 S.W.2d 255 (Ky. 1985)).

[10] *Id.*

[11] Scifres v. Kraft, 916 S.W.2d 779, 781 (Ky. App. 1996).

[12] *Id.*

10 Buford v. Commonwealth, 942 S.W.2d 909, 911 (Ky. App. 1997).

[14] *Id.* (quoting Walters v. Bindner, 435 S.W.2d 464, 467 (Ky. 1968).

[15] *Id.*

Clause of the United States Constitution.[16] This issue is a matter of first impression in Kentucky.[17]

The Commerce Clause simply provides that Congress has the power to "regulate Commerce with foreign Nations, and among the several States[.]"[18] But despite the fact that the Commerce Clause "is phrased merely as a grant of authority to Congress to 'regulate Commerce . . . among the several States,' Art. I, § 8, cl. 3, it is well established that the Clause also embodies a negative command forbidding the States to discriminate against interstate trade."[19] This "negative" or dormant aspect of the Commerce clause "prohibits economic protectionism-that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors."[20] Thus,

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[16] We note that we have the authority to resolve this dispute even though it revolves entirely around interpreting the United States Constitution. *See* Boston Stock Exchange v. State Tax Commission, 429 U.S. 318, 320-321 (1977) ("We agree, of course, that state courts of general jurisdiction have the power to decide cases involving federal constitutional rights where, as here, neither the Constitution nor statute withdraws such jurisdiction'.")

[17] Both the Davises and the Departinent cite other cases in support of their positions. However, with the exception of a case from Ohio (which will be discussed at length *infra),* none of the cited cases are of much significance or help because they are not factually nor legally on all fours with this action. *See,* e.g., Scott K. Attaway, Note, The Case for Constitutional Discrimination in Taxation of Out-of-State Municipal Bonds, 76 B.U. L. Rev. 737, 769 (1996) ("State tax exemption of income earned by residents in transacting with the state does not fall neatly within any of the Supreme Court's established Commerce Clause doctrines."). Therefore, we will not belabor this opinion by specifically distinguishing each case cited to us as the statement of points and authorities in the parties' briefs total thirteen pages.

[18] U.S. Const., Art. I, § 8, cl. 3.

[19] Associated Industries of Missouri v. Lohman, 511 U.S. 641, 646 (1994).

[20] New Energy Co. of Indiana v. Limbach, 486 U.S. 269, 273 (1988).

the "fundamental command"[21] of the Commerce Clause is that "a State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State."[22] As a result, "[s]tate laws discriminating against interstate commerce on their face are 'virtually *per se* invalid.' "[23]

Clearly, Kentucky's bond taxation system is facially unconstitutional as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds.[24] Thus, Kentucky's bond taxation system may be found to be constitutionally valid only if it falls within an exception to the normal rule requiring laws that violate the Commerce Clause on their face to be stricken.[25] So we must evaluate the Department's three main arguments in support of Kentucky's taxation system to determine if the Department has met its burden to show

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[21] Lohman, 511 U.S. at 647.

[22] Armco Inc. v. Hardesty, 467 U.S. 638, 642 (1984).

[23] Fulton Corp. v. Faulkner, 516 U.S. 325, 331 (1996).

[24] Even an author who believes that the separate tax status of in-state and out-of-state ,bonds should be constitutionally permissible agrees that a bond taxation system like Kentucky's is facially unconstitutional. *See* Attaway, 76 B.U. L. Rev. at 739 (1996) ("If subjected to traditional Commerce Clause scrutiny, such discriminatory tax treatment [of bonds] would surely fall under a 'virtually per se rule of invalidity.' ") (quoting Philadelphia v. New Jersey, 437 U.S. 617, 624 (1978)).

[25] Limbach, 486 U.S. at 274 ("Thus, state statutes that clearly discriminate against interstate commerce are routinely struck down, unless the discrimination is demonstrably justified by a valid factor unrelated to economic protectionism.") (internal citations omitted).

that the taxation system in question is constitutionally permissible.[26]

First, one of the Department's main arguments in favor of Kentucky's taxation system is the fact that a similar system has been held to be constitutionally permissible in Ohio. In fact, despite the discriminatory bond taxing system's widespread use and obvious Commerce Clause implications,[27] apparently, only the Ohio courts have been presented with a case challenging it on Commerce Clause grounds.[28] The Ohio Court of Appeals ultimately concluded in Shaper that the bond taxation system was constitutionally permissible. But that court failed fully to analyze the issue. Shaper, though containing a well-written preliminary analysis of the Commerce Clause implications of this discriminatory bond taxing system, "made no attempt to explain why . . . a tax exemption that discriminates against income earned from out-of-state bonds . . . is permissible under the Commerce Clause."[29] Rather, the Shaper court

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[26] C & A Carbone, Inc. v. Town of Clarkstown, N.Y., 511 U.S. 383, 392 (1994) ("Discrimination against interstate commerce in favor of local business or investment is *per se* invalid, save in a narrow class of cases in which the municipality can demonstrate, under rigorous scrutiny, that it has no other means to advance a legitimate local interest."). *See also* Hughes v. Oklahoma, 441 U.S. 322, 337 (1979) (holding that the Court would apply the "strictest scrutiny" to determine if a statute which violates the Commerce Clause on its face was, nevertheless, permissible based upon the State's arguments); Limbach, 486 U.S. at 278-279 (discussing the state's high burden in showing that a statute which violates the Commerce Clause on its face is not invalid because there was no reasonable nondiscriminatory alternative)

[27] At the time Mr. Attaway's law review note was published, at least thirty-seven states had bond taxation systems similar to Kentucky's. *See* 76 B.U. L. Rev. at 738.

[28] Shaper v. Tracy, 647 N.E.2d 550 (Ohio Ct. App. 1994).

[29] 76 B.U. L. Rev. 738, n.6.

"tersely stat [ed] ' in effect, that 'we looked and did not find anything so therefore it must be constitutional.' "[30] Logic dictates, however, that a potentially problematic and constitutionally infirm statute does not become permissible simply because it has not been previously found to be unconstitutional. Rather, a court faced with a direct constitutional challenge to a statute must engage in a searching inquiry to determine whether a challenged statute can pass constitutional muster.[31] Thus, Shaper, though instructive in certain areas, is, in and of itself, insufficient to support the Department's position, meaning that we must examine the Department's other two main arguments.

The Department next argues that the bond taxation system must be found to be constitutional under the Supreme Court's holding in Bonaparte v. Tax Court.[32] In Bonaparte, a taxpayer contended that her state of residence was required by the Full Faith and Credit Clause of the United States Constitution[33] to exempt out-of-state

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[30] *Id.* Mr. Attaway's critique of Shaper is correct because the Shaper court, after examining various theories and inapplicable cases, simply stated its conclusion as follows: "Given the lack of any precedent to apply the Commerce Clause to this type of taxation scheme, we are unable to find R.C. 5747.01 [the Ohio statute in question] unconstitutional as violative of the Commerce Clause." Shaper, 647 N.E.2d at 553-554.

[31] Faced with a similar Commerce Clause challenge to a Kentucky system that taxed out-of-state bank deposits at a higher rate than in-state deposits, the Kentucky Supreme Court opined that a court could not shirk its duty fully to apply the law. Rather, a reviewing court "must enforce constitutional limitations." St. Ledger v. Commonwealth, 912 S.W.2d 34, 39 (Ky. 1995), vacated on other grounds by St. Ledger v. Kentucky Revenue Cabinet, 517 U.S. 1206 (1996).

[32] 104 U.S. 592 (1881).

[33] Article IV, Section 1 of the United States Constitution provides in relevant part that "Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State."

bonds from taxation because the issuing state exempted them. The Supreme Court rejected the taxpayer's argument, holding that "no provision of the Constitution of the United States . . . prohibit [ed] such taxation."[34] However, Bonaparte is ultimately of little value to the case at hand because the Commerce Clause played no role in the Bonaparte court's decision.[35] As the case at hand involves a direct challenge under the dormant Commerce Clause and has nothing to do with the Full Faith and Credit Clause, it logically follows that Bonaparte is neither on point nor controlling.

Finally, the Department relies upon the market participant doctrine to save Kentucky's bond taxation system. The market participant theory "recognizes that when a sovereign acts as a consumer or vendor in commerce, its actions as a market participant are distinct from its actions as a market regulator. The Commerce Clause is directed at the state's actions as a market regulator; therefore, [a State's] actions as a market participant are exempted from Commerce Clause analysis."[36] Stated differently, the market participant theory "differentiates between a State's acting in its distinctive governmental capacity, and a State's acting in the more general capacity of a market participant; only the former is subject to the limitations of the negative Commerce Clause. Thus, for exanple,

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[34] *Id.* at 104 U.S. 594.

[35] *See,* e.g., Donald H. Regan, Siamese Essays: (I) CTS Corp. v. Dynamics Corp of America and Dormant Commerce Clause Doctrine; (II) Extraterritorial State Legislation, 85 Mich. L. Rev. 1865, 1887-1888 (1987) ("The Court in Bonaparte cites no constitutional provision in support of its claim that states cannot legislate extraterritorially. And quite properly not, since the extraterritoriality principle is not to be localized in any single clause. In particular, it is clear that the extraterritoriality principle as it appears in Bon. parte is not based on the commerce clause."); Shaper, 647 N.E.2d at 765 (discussing Bonaparte's holding and noting that it was not based on the commerce Clause).

[36] Shaper, 647 N.E.2d at 763.

when a State chooses to manufacture and sell cement, its business methods, including those that favor its residents, are of no greater constitutional concern than those of a private business."[37]

The Department's market participant argument is unavailing, however. No one could seriously argue against the principle that Kentucky acts as a market participant when it issues bonds. But Kentucky's issuance of bonds is not the issue. Rather, the sole issue is Kentucky's decision to tax only extraterritorial bonds. Thus, the market participant theory is inapplicable as a State's "assessment and computation of taxes" is, clearly, "a primeval governmental activity."[38] Accordingly, "when a state chooses to tax its citizens, it is acting as a market regulator[,]" not as a market participant.[39] Therefore, the Department's market participant argument is without merit.

Having found that the Department's arguments are unavailing, we are left with a situation in which Kentucky's bond taxation scheme is facially unconstitutional under the Commerce Clause; and none of the arguments in favor of its constitutionality offered by the Department or relied upon by the trial court are sufficient to save it. But under the facts presented in this case, we have no choice but to find that Kentudky's system of taxing only extraterritorial bonds runs afoul of the Commerce Clause.[40] Thus, the trial

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[37] Limbach, 486 U.S. at 277 (internal citations omitted).

[38] *Id.*

[39] Shaper, 647 N.E.2d at 764.

[40] As noted previously, although the cases are distinguishable, Kentucky Courts have previously struck down legislation for violating the Commerce Clause, such as when the Kentucky Supreme Court struck down statutes providing for different levels of *ad valorem* taxation on in-state and out-of-state bank deposits. *See* St. Ledger, 912 S.W.2d 34, and St. Ledger v. Commonwealth, 942 S.W.2d 893 (Ky. 1997).

court's decision to grant summary judgment to the Department was erroneous.[41]

B. Standing.

The trial court found that the Davises lacked standing to assert claims on behalf of all non-individual claimants (i.e., corporations, trusts, estates, etc.) because they had not shown that they had been forced to pay any taxes on extra-territorial bonds on behalf of those types of entities. On appeal, the Davises contend that the trial court confused the concept of standing with the somewhat related issues involved in class certification. We agree.

Class actions in Kentucky are governed by Rules of Civil procedure (CR) 23.01-23.04. The Davises' complaint sets forth their intention to prosecute their claims as a class action on behalf of all individuals, corporations, trusts, estates, etc. CR 23.03(1) provides that "[a]s soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether it is to be so maintained." Thus, "[i]n a class action a plaintiff generally files a motion seeking certification of the class even though this is not expressly required by statute or rule."[42] In the case at hand, the Davises had not filed a motion for class certification before the Department filed its motion for summary judgment. So any issues regarding the propriety of class certification were not before the trial court. Rather, the only issues before the trial court were whether the bond taxation system in question was constitutional and whether the Davises had basic standing to file the action.

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[41] The trial court made no explicit findings regarding the Davises' Equal Protection arguments. Given our Commerce Clause analysis, we also find it unnecessary to engage in an Equal Protection analysis.

[42] 59 Am.Jur.2d *Parties* § 98 (2002).

The question of standing only goes to whether an individual is entitled to have his or her claims resolved by a court.[43] Thus, although standing is a threshold issue and a prerequisite for all actions, in order to demonstrate standing, a party need only show that a case or controversy exists between that party and the defendant.[44] Only after a plaintiff has established personal standing in a putative class action may a court consider the separate issue of whether the plaintiff will be able to represent the proposed class adequately under the guidelines of CR 23.01-23.04.[45]

In the case at hand, the trial court found that the Davises had personal standing to assert claims regarding the bond taxation issue.[46] Thus, the Davises have standing. The question of whether the Davises may properly represent corporations, trusts, and estates comes into play only when the issue of class action certification is presented. Thus, the portion of the trial court's opinion finding that the Davises lack standing is vacated. Upon remand, the Davises will, presumably, quickly move for class certification, at which time, the trial court may determine all of the issues involved in resolving such a matter, including whether the Davises can properly represent any corporations, trusts or estates.[47]

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[43] *See*, e.g., Fallick v. Nationwide Mutual Ins. Co., 162 F.3d 410, 422 (6th Cir. 1998).

[44] *Id.* at 422-423.

[45] *Id.* at 423.

[46] The trial court's summary judgment order states that "[t]he plaintiffs do maintain standing in regard to KRS 141.020, which relates to an individual income tax paid by them." Appellants' Brief, Appendix 3, p. 4.

[47] The Davises ask us to order the trial court to certify this as a class action. We decline that invitation, however, as such an issue is one which must be initially determined by the trial court.

IV. CONCLUSION.

For the foregoing reasons, the Jefferson Circuit Court's order granting summary judgment to the Department of Revenue is vacated; and this case is remanded for further proceedings consistent with this opinion.

ALL CONCUR.

BRIEFS AND ORAL ARGUMENT FOR APPELLANTS:
Irvin D. Foley
David W. Gray
Anthony Raluy
Louisville, Kentucky

John R. Wylie
Chicago, Illinois

BRIEF AND ORAL ARGUMENT FOR APPELLEES:
Douglas M. Dowell
Frankfort, Kentucky

SUPREME COURT OF KENTUCKY

2006-SC-105-D
(2004-CA-1940-MR)

DEPARTMENT OF REVENUE, ETC.,
ET AL. - - - - - - - - - - *Movants*

v.

GEORGE W. DAVIS and
CATHERINE DAVIS - - - - - *Respondents*

Jefferson Circuit Court
2003-CI-3282

ORDER DENYING DISCRETIONARY REVIEW

The motion for discretionary review of the decision of the Court of Appeals is denied.

Minton, J., not sitting.

ENTERED August 17, 2006.

/s/ Joseph E. Lambert
Chief Justice

NO. 03CI03282

JEFFERSON CIRCUIT COURT

DIVISION ONE

GEORGE W. DAVIS and
CATHERINE DAVIS - - - - - - - *Plaintiffs*

v.

REVENUE CABINET, COMMONWEALTH
OF KENTUCKY, et al. - - - - - - *Defendants*

ORDER GRANTING DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

This matter came before the Court on the motion of defendants Commonwealth of Kentucky Revenue Cabinet and Commonwealth of Kentucky Finance and Administration Cabinet ("defendants") for summary judgment. Plaintiffs George W. Davis and Catherine V. Davis ("plaintiffs") filed a response on August 22, 2003. The defendants filed a reply on September 12, 2003. Oral arguments were held on September 29, 2003. The plaintiffs were represented by attorneys Irvin D. Foley, M. Stephen Dampier, Tammy McClendon Stokes, Scott Barrett and Donn H. Wray. The defendants were represented by attorneys Debra H. Eucker and Douglas M. Dowell. The official proceedings were recorded on videotape no. 30-01-03-079-A-1.

FACTUAL BACKGROUND

On April 11, 2003, the plaintiffs filed a class action complaint for a declaratory judgment, injunction and tax refunds. The plaintiffs brought this action on their behalf and as representatives of a class composed of all person who have paid Kentucky Income Tax ("KIT") on interest income derived from out-of-state municipal bonds and/or their political subdivisions during the class period.

LEGAL ANALYSIS

In Steelvest, Inc. v. Scansteel Service Center, Ky., 807 S.W.2d 476 (1991), the Court looked to the holding in Paintsville Hospital Co. v. Rose, Ky., 683 S.W.2d 255 (1985) for the standard for summary judgment in Kentucky. In Paintsville Hospital, the Court found that summary judgment is proper only when the movant shows that the adverse party cannot prevail under any circumstances. There must be no genuine issues of material fact, and the moving party must be entitled to judgment as a matter of law. Scifres v. Kraft, Ky. App., 916 S.W.2d 779, 780 (1996). The record must be viewed in the light most favorable to the party opposing the motion for summary judgment, and all doubts are to be resolved in his favor. Dossett v. New York Mining and Manufacturing Co., Ky., 451 S.W.2d 843 (1970).

The defendants assert that the plaintiffs lack standing to challenge the constitutionality of the provisions of Kentucky income tax law relating to corporations, estates, trusts and fiduciaries. It is averred that the plaintiffs have standing only to challenge the individual income tax imposed by KRS 141.020. The defendants also argue that KRS 141.020 is entitled to a strong presumption of constitutionality and does not violate the Commerce Clause or Equal Protection Clause of the United States Constitution. The defendants contend that if, in fact, KRS 141.010(10)(c) is unconstitutional, the remainder of the income tax law would still be valid and operational.

In their response, plaintiffs argue that they have standing to assert their claims. They also contend that Kentucky's taxation of interest on bonds issued by other states and their political subdivisions unconstitutionally discriminates against interstate commerce and violates the Equal Protection Clause of the United States Constitution. The plaintiffs concur with the defendants' position that the Court need not invalidate the entire Kentucky Income Tax statute in order to find a part of it unconstitutional.

Intheir reply, the defendants assert that Bonaparte v. Tax Court, 104 U.S. 592 (1881) is controlling and disposi-

tive of the plaintiffs claims. Additionally, the defendants argue that the plaintiffs cannot seek tax refunds by a direct original action such as the one before this Court.

Before the Court can reach the merits of this case, the issue of standing must be resolved. The United States Supreme Court has provided three requirements for standing:

> (1) The plaintiff must have suffered an "injury in fact" — an invasion of a legally protected interest which is (a) concrete and particularized, and (b) actual or imminent, and
>
> (2) There must be a causal connection between the injury and the conduct complained of, and
>
> (3) It must be likely, as opposed to merely speculative, that the injury will be redressed by a favorable decision

Lujan v. Defenders of Wildlife, 504 U.S. 555, 560-61 (1992); Rosen v. Tennessee Commissioner of Finance and Administration, 288 F.3d 918 (6th Cir. 2002). The burden of establishing standing is on the party seeking federal court action. Lujan at 561-62. It is well settled that, at the commencement of litigation, class representatives without personal standing cannot base standing on injuries suffered by members of the class but which they themselves have not or will not suffer. Warth v. Seldin, 422 U.S. 490, 501 (1975). If the plaintiffs apply for and receive certification, they would have standing in respect to the claims included in their original complaint. The certification of a class requires a finding that the named plaintiffs had a stake. Since the plaintiffs in the case-at-bar have acknowledged that they have not applied for certification at this time, the Court must decide the issue of standing by considering the current status of the parties.

The Court finds that the plaintiffs lack standing in regard to KRS 141.030 and KRS 141.040. As stated by the defendants, these two statutes pertain to the income taxes paid by corporations, estates, trusts and fiduciaries. The plaintiffs cannot establish that they have suffered any in-

jury, in fact, as required by the three prong test in Lujan, supra. The plaintiffs do maintain standing in regard to KRS 141.020, which relates to an individual income tax paid by them.

There is a clear presumption in favor of the constitutionality of a statute. Dawson v. Birenbaum, Ky., 968 S.W.2d 663 (1998). The test of the constitutionality of a statute is whether it is "unreasonable or arbitrary." Buford v. Commonwealth, Ky. App., 942 S.W.2d 909, 911 (1997); Moore v. Ward, Ky., 377 S.W.2d 881 (1964). The statute will be determined to be constitutionally valid if a reasonable, legitimate public purpose for it exists, whether or not we agree with its wisdom or expediency. Walters v. Bindner, Ky., 435 S.W.2d 464, 467 (1968).

When a state issues municipal bonds, it participates in the bond market by supplying bonds to the market and paying interest on those bonds. Whether the state is viewed as a market-participant or as using its proprietary powers, or both, it clearly may pay a higher rate of interest to resident purchasers based upon the theories of distributing state created benefits and market participation. This practice can be analogized to granting property tax breaks to various businesses, but not to others, in order to encourage businesses to remain in the state. Reeves v. Stake, 447 U.S. 429 (1980); see also Scott K. Attaway, Note, The Case for Constitutional Discrimination in Taxation of Out-of-State Municipal Bonds, 76 B.U. L. Rev. 737 (1990). Considering the entire transaction, the tax exemption granted to resident purchasers of municipal bonds qualifies under those doctrines which permit burdens on interstate commerce in certain limited contexts and is, therefore, not the type of burden with which the Commerce Clause is concerned. Hughes v. Alexandria Scrap Corp. 426 U.S. 794, 805 (1976); Attaway at 760-761.

States have a legitimate interest in attracting local funds for local public works projects. Constitutionally permissible resident preferences encourage states and cities to improve the lives of their citizens by keeping the ben-

efits they generate within their borders. Each state has a legitimate interest in drawing upon a major source of tax revenue while creating an incentive for investors to purchase state bonds. The purchasers ultimately become the major beneficiaries of the issuance of the bonds for state issues such as capital improvements as quality schools, hospitals and roads. Shaper v. Tracy, 647 N.E.2d 550 (Ohio Ct. App. 1994); Attaway at 768.

The Court finds that KRS 141.020 has a reasonable, legitimate public purpose. Therefore, the statute is constitutional, while the plaintiff may not agree with the statute's purpose, that fact alone does not require the Court to make a finding of unconstitutionality.

IT IS HEREBY ORDERED that the motion of defendants Commonwealth of Kentucky Revenue Cabinet and Commonwealth of Kentucky Finance and Administration Cabinet for summary judgment is **GRANTED.**

Ths is a final and appealable order, and there is no just cause for delay.

/s/ BW
JUDGE BARRY WILLETT
JEFFERSON CIRCUIT COURT

cc: Irvin D. Foley, Esq./David W. Gray, Esq./Anthony G. Raluy, Esq./Charles R. Watkins, Esq./John R. Wylie, Esq./M. Scott Barrett, Esq./Dennis T. Trainor, Esq./ David J. Guin, Esq./Tammy M. Stokes, Esq./M. Stephen Dampier, Esq./Hart L. Robinovitch, Esq./Donn H. Wray, Esq.

Douglas M. Dowell, Esq./ Debra H. Eucker, Esq.

KY. REV. STAT. ANN. § 141.010

As used in this chapter, unless the context requires otherwise:

* * * * *

(7) "Individual" means a natural person;

* * * * *

(9) "Gross income" in the case of taxpayers other than corporations means "gross income" as defined in Section 61 of the Internal Revenue Code;

(10) "Adjusted gross income" in the case of taxpayers other than corporations means gross income as defined in subsection (9) of this section minus the deductions allowed individuals by Section 62 of the Internal Revenue Code and as modified by KRS 141.0101 and adjusted as follows, except that deductions shall be limited to amounts allocable to income subject to taxation under the provisions of this chapter, and except that nothing in this chapter shall be construed to permit the same item to be deducted more than once:

* * * * *

(c) Include interest income derived from obligations of sister states and political subdivisions thereof;

* * * * *

(11) "Net income" in the case of taxpayers other than corporations means adjusted gross income as defined in subsection (10) of this section, minus the standard deduction allowed by KRS 141.081, or, at the option of the taxpayer, minus the deduction allowed by KRS 141.0202, minus any amount paid for vouchers or similar instruments that provide health insurance coverage to employees or their families, and minus all the deductions allowed individuals by Chapter 1 of the Internal Revenue Code as modified by KRS 141.0101 except those listed below, except that deductions shall be limited to amounts allocable to income subject to taxation under the provisions of this chapter and that nothing in this chapter shall be

construed to permit the same item to be deducted more than once:

* * * * *

(16) "Taxable year" means the calendar year or fiscal year ending during such calendar year, upon the basis of which net income is computed, and in the case of a return made for a fractional part of a year under the provisions of this chapter or under regulations prescribed by the commissioner, "taxable year" means the period for which the return is made;

(17) "Resident" means an individual domiciled within this state or an individual who is not domiciled in this state, but maintains a place of abode in this state and spends in the aggregate more than one hundred eighty-three (183) days of the taxable year in this state;

(18) "Nonresident" means any individual not a resident of this state;

* * * * *

KY. REV. STAT. ANN. § 141.020

(1) An annual tax shall be paid for each taxable year by every resident individual of this state upon his entire net income as defined in this chapter. The tax shall be determined by applying the rates in subsection (2) of this section to net income and subtracting allowable tax credits provided in subsection (3) of this section.

* * * * *

(4) An annual tax shall be paid for each taxable year as specified in this section upon the entire net income except as herein provided, from all tangible property located in this state, from all intangible property that has acquired a business situs in this state, and from business, trade, profession, occupation, or other activities carried on in this state, by natural persons not residents of this state. A nonresident individual shall be taxable only upon the amount of income received by the individual from labor performed, business done, or from other activities in this

state, from tangible property located in this state, and from intangible property which has acquired a business situs in this state; provided, however, that the situs of intangible personal property shall be at the residence of the real or beneficial owner and not at the residence of a trustee having custody or possession thereof. The remainder of the income received by such nonresident shall be deemed nontaxable by this state.

* * * * *

(6) An individual who becomes a resident of Kentucky during the taxable year is subject to taxation as prescribed in subsection (4) of this section prior to establishing such residence and as prescribed in subsection (1) of this section following the establishment of such residence.

(7) An individual who becomes a nonresident of Kentucky during the taxable year is subject to taxation, as prescribed in subsection (1) of this section, during that portion of the taxable year that the individual is a resident and, as prescribed in subsection (4) of this section, during that portion of the taxable year when the individual is a nonresident.

* * * * *

103 KY. ADMIN. REGS. 17:060

* * * * *

Section 1. Residents. The entire net income of a full-year resident individual shall be subject to Kentucky income tax regardless of its source. Income from out-of-state sources shall not be exempt. The adjustments to gross income and itemized deductions allowed under KRS 141.010(10) and (11) of a full-year resident shall not be limited to those paid in Kentucky.

Section 2. Persons Becoming Residents During the Year. (1) Persons who become Kentucky residents during the year shall be subject to Kentucky individual income tax upon their entire net incomes from any source after

becoming Kentucky residents and upon their incomes from Kentucky sources prior to becoming Kentucky residents.

* * * * *

Section 3. Persons Becoming Nonresidents During the Year. (1) Persons who are Kentucky residents, but become nonresidents during the year, shall be subject to Kentucky individual income tax upon their entire net incomes from all sources while they are Kentucky residents, and upon their incomes from Kentucky sources after becoming nonresidents.

* * * * *

Section 4. Nonresidents. (1) Any net income of a nonresident shall be subject to Kentucky income tax if it is derived from services performed in Kentucky or from property located in Kentucky. Income from sources outside Kentucky shall not be subject to Kentucky income tax.

* * * * *